

methodology that would be binding in future represcription proceedings.

5. Cost of Preferred Stock

81. In Docket 84-800, the Commission determined that preferred stock should be calculated by dividing the annual dividend on that stock by the net proceeds from its issuance.⁸⁶ Because the RHCs had no preferred stock outstanding, we did not address any issue regarding preferred stock in the 1990 represcription proceeding.

82. We have no wish to complicate future represcription proceedings with disputes regarding the cost of preferred stock, and a subsequent portion of this Notice⁸⁷ invites comment on whether we should include a preferred stock component within the capital structure we use in determining the cost of capital for LEC interstate access service. If we decide to include such a component, we question whether we should continue to require a separate calculation of the cost of each class of preferred stock. As a result, we invite comment on how we should determine the cost of preferred stock, should such a determination be necessary. In this regard, we ask interested persons to address whether the methods we propose for determining the cost of debt for LEC interstate access service should be applied to determine the cost of preferred stock. For instance, if we were to calculate the cost of debt component by dividing annual interest expense by average outstanding debt,⁸⁸ we could also calculate the preferred stock component by dividing annual dividends on preferred stock by total net proceeds from the issuance of outstanding preferred stock. Similarly, if we were to use a sample of bonds rated at least "Aa" to determine long-term debt costs,⁸⁹ we could use the resulting cost of long-term debt as the cost of preferred stock. We invite the commenters to discuss these approaches as well as other alternatives for calculating the cost of preferred stock. We also invite comment on whether we should select a method for calculating that cost that would be binding in future represcription proceedings.

6. Capital Structure

a. Basis

83. The current Part 65 rules specify the use of a composite of the RHCs' capital structures in calculating a weighted average cost of capital for LEC

⁸⁶ See 47 C.F.R. §65.302; see also Docket 84-800 Supplemental Notice, at para. 101.

⁸⁷ Part III(E)(6), infra.

⁸⁸ See Part III(E)(4), supra.

⁸⁹ Id.

interstate access service.⁹⁰ We used this composite in the 1990 represcription proceeding, despite LEC arguments that we should use a composite of the BOCs' capital structures. We determined that while neither composite precisely depicted the proportions of debt and equity that supported interstate access service at that time, both produced a capital structure "well within the limits traditionally considered acceptable for regulated telephone operations."⁹¹ We used the RHCs' composite capital structure in our cost of capital calculation, however, because we believed that using the BOCs' composite structure would create an undesirable incentive for future RHC manipulation of BOC capital structures.⁹²

84. Although we believe that the Part 65 approach to capital structure was an acceptable method for determining an appropriate capital structure for the interstate access operations of the remaining rate of return LECs, we believe that other approaches may provide more accurate capital structures in future represcription proceedings. Therefore, we invite the commenters to propose alternatives to the current approach that would be suited to determining a capital structure for the remaining rate of return LECs. We request the commenters to address whether the various alternatives would produce capital structures within traditionally acceptable limits and further our goal of simplifying future represcription proceedings, without providing incentives for manipulation.

85. We also request comment on three specific alternatives in addition to the capital structures methodologies considered in the 1990 represcription proceeding. First, if we were to use the embedded costs of debt of LECs that have \$100 million or more in annual revenue or their holding companies to determine the cost of debt component, we could use the corresponding capital structure. Second, we could use a composite of a representative sample of the remaining rate of return LECs' capital structures to determine the capital structure component. Our preliminary analysis indicates that this approach would produce a capital structure within traditionally acceptable limits and would be consistent with our goal of simplifying future represcription

⁹⁰ 47 C.F.R. §§65.201, 65.300, 65.304. Part 65 also specifies the use of comparable firms' capital structures in calculating a weighted average cost of capital for the comparable firms analysis embodied in the rules. 47 C.F.R. §65.400. However, the Commission has never placed much reliance on the Part 65 comparable firms analysis, and, in fact, waived such required filings in the 1990 represcription proceeding.

⁹¹ 1990 Represcription Order, 5 FCC Rcd at 7511, para. 34. Neither the RHCs nor the BOCs had preferred stock in their capital structures.

⁹² Id. Although any future represcription would not affect the sharing zones for price cap LECs, it would change their universal service fund distributions and long term support contributions.

proceedings.⁹³ We also believe that, since a sample would be used, there would be little incentive for manipulation.

86. Third, we could select a specific capital structure that would be conclusive in future represcription proceedings. As we have stated, a goal in this proceeding is to simplify the represcription process. Based on past experience, we realize that any capital structure methodology that is not fixed will generate considerable controversy during the course of a represcription proceeding. Therefore, we intend to consider selecting a fixed capital structure based on the proposed capital structures we discuss above. We believe that such a structure might simplify the represcription process, minimize incentives for future manipulation, and, as long as the structure fell within traditionally acceptable limits, be permissible. Therefore, we invite comment on whether we should adopt such a capital structure for use in future represcription proceedings. We also invite comment on whether we should separately identify short-term debt and preferred stock components within the capital structure and, if so, how we should perform that identification.

b. Computation

87. Section 65.300(a) of our rules provides that the capital structure component of the weighted average cost of capital should exclude sources of capital that are (1) not investor-supplied, (2) otherwise subtracted from a carrier's rate base pursuant to Commission orders under the authority of Section 203 of the Communications Act,⁹⁴ or (3) treated as "zero cost" sources.⁹⁵ We believe this computation reasonable and propose to retain it.

7. State Cost of Capital Determinations

88. Section 65.201 of our rules⁹⁶ requires RHCs to provide state cost of capital information in their initial submissions. This information must include each state cost of capital determination that is applicable to the intrastate exchange carrier operations of the RHCs' operating companies as of the initial submissions' due date as well as a certified copy of each state decision establishing those costs of capital. In the 1990 represcription proceeding, we gave weight to the most recent state cost of equity determinations as a check on the reasonableness of the parties' current cost of

⁹³ This analysis reflects the capital structures set forth in United States Telephone Association, Statistics of the Local Exchange Carriers for the Year 1990 (1991). We invite comment on whether those capital structures provide a representative sample of the remaining rate of return LECs' capital structures.

⁹⁴ 47 U.S.C. §203.

⁹⁵ 47 C.F.R. §65.300(a).

⁹⁶ 47 C.F.R. §65.201.

equity estimates.⁹⁷

89. We continue to believe that state cost of capital determinations, and in particular state cost of equity determinations, can provide a useful tool in assessing the reasonableness of other cost of capital estimates. Therefore, we propose to continue to require the filing of such information for inclusion in the record in rescription proceedings. We invite comment on whether we should require the filing of state cost of capital determinations applicable to the largest of the remaining rate of return LECs in lieu of, or in addition to, the RHC-related determinations that must be filed under our current rule. To reduce the burden of our filing requirements, we also propose to eliminate the requirement that the copies of the state decisions be certified. We invite comment on these matters.

8. Miscellaneous Issues

a. Rescription Rules for Interexchange Carriers

90. As previously stated, the current Part 65 rules contain rules for rescribing a rate of return for interexchange carriers that are required by Commission order to be regulated on a rate of return basis.⁹⁸ The Commission has only used those rules once, rescribing a rate of return for AT&T in the 1986 rescription proceeding.⁹⁹ Since that time, we have removed AT&T entirely from rate of return regulation. The Commission has never required application of these rules to any other interexchange carrier, and we do not foresee their use. Therefore, we tentatively conclude that these rules are unnecessary and seek comment on their elimination.

b. Relationship to Price Cap LECs' New Services

91. Under price cap regulation, "new services" of price cap LECs remain under rate of return regulation until the first annual price cap filing occurring at least one year after their implementation.¹⁰⁰ In our ONA/Part 69 proceeding, we allowed price cap LECs to seek rates of return on these services that are higher than the 11.25% prescribed rate of return used in developing the initial LEC price cap rates.¹⁰¹ We intend to address questions regarding

⁹⁷ 1990 Rescription Order, 5 FCC Rcd at 7513, paras. 53; id. at 7528, para. 180.

⁹⁸ 47 C.F.R. §65.500(a). The rescription rules for interexchange carriers are Sections 65.500 and 65.510 of our rules, 47 C.F.R. §§65.500, 65.510.

⁹⁹ 1986 Rescription Order, at paras. 53-88.

¹⁰⁰ LEC Price Cap Order, 5 FCC Rcd at 6825, para. 319.

¹⁰¹ ONA/Part 69 Order, 6 FCC Rcd at 4531, para. 43. We referred to this increment above 11.25% as a risk premium. In contrast, this Notice uses risk premium to refer to the difference between a company's or group of companies'

pricing for new services in our ONA/Part 69 proceeding, rather than in this proceeding.

c. Calculation Specificity

92. The Part 65 rules require most cost of capital calculations to be carried out to the eighth decimal place.¹⁰² Our experience has been that this level of specificity does not increase overall accuracy enough to outweigh its burdens. We tentatively conclude that cost of capital calculations need only be carried out to the second decimal place. We seek comment on this tentative conclusion.

IV. ENFORCEMENT PROCEDURES

A. Background

93. The rules adopted in Docket 84-800 also provide for the automatic refund, with interest, of earnings exceeding what the rules refer to as "the maximum allowable rate of return." For LECs, this rate of return equals the prescribed rate of return plus buffer zones of 25 basis points on overall interstate access earnings and 40 basis points on earnings within each of three access categories (common line, traffic sensitive, and special). Under the rules, LECs must monitor their interstate access earnings over two-year enforcement periods. When those earnings exceed the "maximum allowable rate of return" on either an overall or an access category basis, the rules require refund of the excess earnings through prospective rate adjustments or direct distributions to customers.¹⁰³

94. In the Automatic Refund Decision, the D.C. Circuit remanded this automatic refund rule to the Commission.¹⁰⁴ The court held that the rule before it was inconsistent with the rate of return prescription it purported to enforce. This inconsistency arose, according to the court, because the prescription created a balance point, representing both the minimum and maximum return that the Commission could have prescribed.¹⁰⁵ In the court's view, the automatic refund rule upset this balance by requiring carriers to refund any earnings above the authorized rate of return plus a buffer, without allowing the carriers to recoup earnings below the authorized rate of return.¹⁰⁶

cost of equity and the yield on a "risk-free" investment. See Part III(E)(3)(b), supra.

¹⁰² E.g., 47 C.F.R. §§65.300; 65.304(d).

¹⁰³ 47 C.F.R. §§65.700-65.703.

¹⁰⁴ Automatic Refund Decision, supra.

¹⁰⁵ Id., 836 F.2d at 1390.

¹⁰⁶ Id., 836 F.2d at 1390-91.

95. Our enforcement efforts since the Automatic Refund Decision have focused largely on complaints alleging damages resulting from LEC violations of the prescribed rate of return.¹⁰⁷ We do not intend to resolve issues regarding those complaints in this rulemaking.

B. Discussion

1. Automatic Refund Decision

96. We acknowledge that the Commission may not have made its understanding of the rate of return it prescribes sufficiently clear in prior orders. However, subsequent to the Automatic Refund Decision, we emphatically explained our position:

In light of the ruling in the Automatic Refund Decision, in which the Court of Appeals determined that our automatic refund provision was at odds with our own understanding of our rate of return prescription, we wish to clarify that we do not view this prescription as "both a maximum and a minimum." That is, it does not represent a unique balance point such that "[i]f the rate were higher, the balance would tip in favor of the investor; if lower, it would tip in favor of the consumer." Our accumulated experience with rate of return prescriptions, and our review of the cost of capital evidence in this proceeding, convince us that there is no such point. Indeed, even the lower boundary of our range of cost of capital estimates does not represent a bright line such that a company earning just below that level would be forced out of business. We believe there is a substantial gap between an earnings level that is fully adequate to assure attraction of capital on favorable terms, and an earnings level which, if sustained over time, would be confiscatory (footnotes omitted).¹⁰⁸

97. We reiterate that the rate of return we prescribe is a point within a broad zone of reasonableness.¹⁰⁹ This point is neither the maximum nor minimum

¹⁰⁷ See, e.g., AT&T v. Northwestern Bell Telephone Co., 5 FCC Rcd 143 (1990), appeal dismissed sub nom. Mountain States Telephone & Telegraph Co., et al. v. FCC, Nos. 90-9510, et al. (10th Cir. Dec. 13, 1991) (per curiam); MCI Telecommunications Corp. v. Pacific Northwest Bell Telephone Co., 5 FCC Rcd 216 (1990), recon., 5 FCC Rcd 3463 (1990), appeal dismissed sub nom. Mountain States Telephone & Telegraph Co., supra.

¹⁰⁸ 1990 Represcription Proceeding, 5 FCC Rcd at 7532, para. 217.

¹⁰⁹ As we explained in the 1990 Represcription Proceeding, "the more appropriate visual metaphor for the balance we have in mind would be a rocking chair that can be made to tip over frontwards or backwards, but that will remain upright through a considerable part of its total range of motion." Id. at 7540, n.313.

necessary to meet constitutional standards. Instead, it is a point selected, based on our consideration of all relevant factors, from within a zone that is narrower than the zone bounded on the lower end by the constitutional minimum.¹¹⁰ We will continue to adhere to this view of our rate of return prescriptions.

2. Enforcement Mechanisms

98. In view of the nature of our rate of return prescriptions, we believe we have considerable discretion in selecting among a wide range of possible enforcement mechanisms. For instance, the Automatic Refund Decision implies that we may rely solely on our tariff review and complaint processes to enforce our rate of return prescriptions. We may also, as the D.C. Circuit made clear in New England Tel.,¹¹¹ order carriers to make refunds when they violate a rate of return prescription. We believe that we may exercise this power to require refunds either through issuing orders to show cause in specific cases or through a refund rule. Finally, we may impose forfeitures of up to \$12,000 a day for violations of an outstanding prescription.¹¹² We invite comment on where within this range of possibilities our enforcement mechanisms should fall. We tentatively conclude that we should rely on the tariff review and complaint processes as our primary enforcement mechanisms, and that we should repeal our automatic refund rule. We invite comment on these tentative conclusions.

99. We also invite comment on whether we should supplement the tariff review and complaint processes with an automatic refund rule. With no interexchange revenues and only a small portion of LEC interstate access revenues remaining under rate of return regulation, there would appear to be substantially less need for an automatic refund rule than there was when the rule reviewed in the Automatic Refund Decision was adopted in 1985. We believe that the other enforcement mechanisms at our disposal will let us deter violations of our rate of return prescriptions and, in the event violations occur, allow us to correct them. We invite interested persons to address whether these mechanisms would be sufficient to deter and correct violations of rate of return prescriptions in the absence of an automatic refund rule.

100. Finally, to ensure a complete record in the event we decide to adopt a new automatic refund rule, we invite comment on alternatives to the rule reviewed in the Automatic Refund Decision. Commenters should consider whether a new refund rule should calculate refunds on an overall interstate access basis, rather than on an access category basis as in the prior rule. Commenters should also consider whether different buffer zones and enforcement periods would address the D.C. Circuit's concerns in the Automatic Refund

¹¹⁰ Id. at 7529, paras. 189-90.

¹¹¹ New England Telephone and Telegraph Co. v. FCC, 826 F.2d 1101 (D.C. Cir. 1987), cert. denied, 109 S. Ct. 1492 (1989).

¹¹² 47 U.S.C. §205(b).

Decision.¹¹³

3. Buffer Zones

101. Regardless of our action in regard to an automatic refund rule, we seek comment on whether the current buffer zones are adequate for the remaining rate of return LECs. We invite comment on whether these carriers' earnings fluctuate more widely than the industry as a whole and, if so, what buffer zones might be appropriate.¹¹⁴

4. Enforcement Period

102. We also seek comment on whether we should retain the current two-year enforcement period. This period is tied to the two-year represcription cycle in the current Part 65 rules. Since we propose to abandon that cycle,¹¹⁵ we seek comment on whether we should also change the enforcement period and, if so, what enforcement period we should select.

V. DEFERRAL OF THE NEXT REPRESRIPTION PROCEEDING

103. In the 1991 Deferral Order, the Bureau deferred until August 3, 1992, the initial submissions scheduled to be filed January 3, 1992.¹¹⁶ The Bureau determined that a deferral would let us attempt to refine and possibly streamline the Part 65 rules prior to initiating a new represcription proceeding. The Bureau stated that this task might require an additional notice of proposed rulemaking. In this Notice, we propose wholesale changes in our represcription rules and, in particular, to replace the current two-year represcription cycle with a trigger based on changes in the capital markets and to simplify the requirements for initial submissions. In these circumstances, we see no reason to begin a represcription proceeding on August 3, 1992, as would happen under the Bureau order, particularly since we are committed to moving forward with this proceeding as expeditiously as possible. We find that it would serve the public interest to defer the filing of initial submissions while we are considering the matters raised in this Notice. Accordingly, we defer that filing date pending further action in this rulemaking. In this regard, we have no reason to believe that the current prescription will not continue to result in rates within a zone of reasonableness. We will revisit this deferral if changes in the capital markets indicate that a represcription proceeding is warranted.

¹¹³ Automatic Refund Decision, 836 F.2d at 1390-1393.

¹¹⁴ In addressing this matter, we will consider any comments filed on appropriate earnings levels in our proceeding on regulatory reform for rate of return LECs. See Regulatory Reform Notice, supra.

¹¹⁵ See Part III(C), supra.

¹¹⁶ 1991 Deferral Order, 6 FCC Rod at 5863, para. 5.

VI. PROCEDURAL MATTERS

A. Ex Parte

104. This is a non-restricted notice and comment rulemaking proceeding. Ex parte presentations are permitted, except during the Sunshine Agenda period, provided they are disclosed as provided in the Commission's rules.¹¹⁷

B. Regulatory Flexibility

105. We certify that the Regulatory Flexibility Act of 1980 does not apply to this rulemaking proceeding because if the proposed rule amendments are promulgated, there will not be a significant economic impact on a substantial number of small business entities, as defined by Section 601(3) of the Regulatory Flexibility Act.¹¹⁸ Because of the nature of local exchange and access service, the Commission has concluded that small telephone companies are dominant in their fields of operation and therefore are not "small entities" as defined by that act.¹¹⁹ The Secretary shall send a copy of this Notice of Proposed Rulemaking and Order, including the certification, to the Chief Counsel for Advocacy of the Small Business Administration in accordance with Section 603(a) of that act.¹²⁰

C. Comment Dates

106. We invite comment on the proposals and tentative conclusions set forth above. Pursuant to applicable procedures set forth in Sections 1.415 and 1.419 of the Commission's Rules,¹²¹ interested parties may file comments on or before September 11, 1992, and reply comments on or before October 13, 1992. To file formally in this proceeding, you must file an original and four copies of all comments, reply comments, and supporting comments. If you want each Commissioner to receive a personal copy of your comments, you must file an original plus nine copies. You should send comments and reply comments to Office of the Secretary, Federal Communications Commission, Washington, D.C. 20554. Comments and reply comments will be available for public inspection during regular business hours in the Dockets Reference Room of the Federal Communications Commission, 1919 M Street, N.W., Washington, D.C. 20554.

VII. ORDERING CLAUSES

¹¹⁷ See generally 47 C.F.R. §§1.1202, 1.1203, 1.1206(a).

¹¹⁸ 5 U.S.C. §601(3).

¹¹⁹ See MTS and WATS Market Structure, 93 FCC 2d 241, 338-39 (1983).

¹²⁰ 5 U.S.C. §§603(a).

¹²¹ 47 C.F.R. §§1.415, 1.419.

107. Accordingly, IT IS ORDERED that, pursuant to Sections 1, 4(i), 4(j), 201, 202, 204, 205, 218-220, and 403 of the Communications Act of 1934, as amended, 47 U.S.C. §§151, 154(i), 154(j), 201-02, 204-05, 218-20, and 403, NOTICE IS HEREBY GIVEN of proposed amendments to Parts 65 and 69 of the Commission's Rules, 47 C.F.R. §§65.1 et seq. & §§69.1 et seq., described in this Notice of Proposed Rulemaking.¹²²

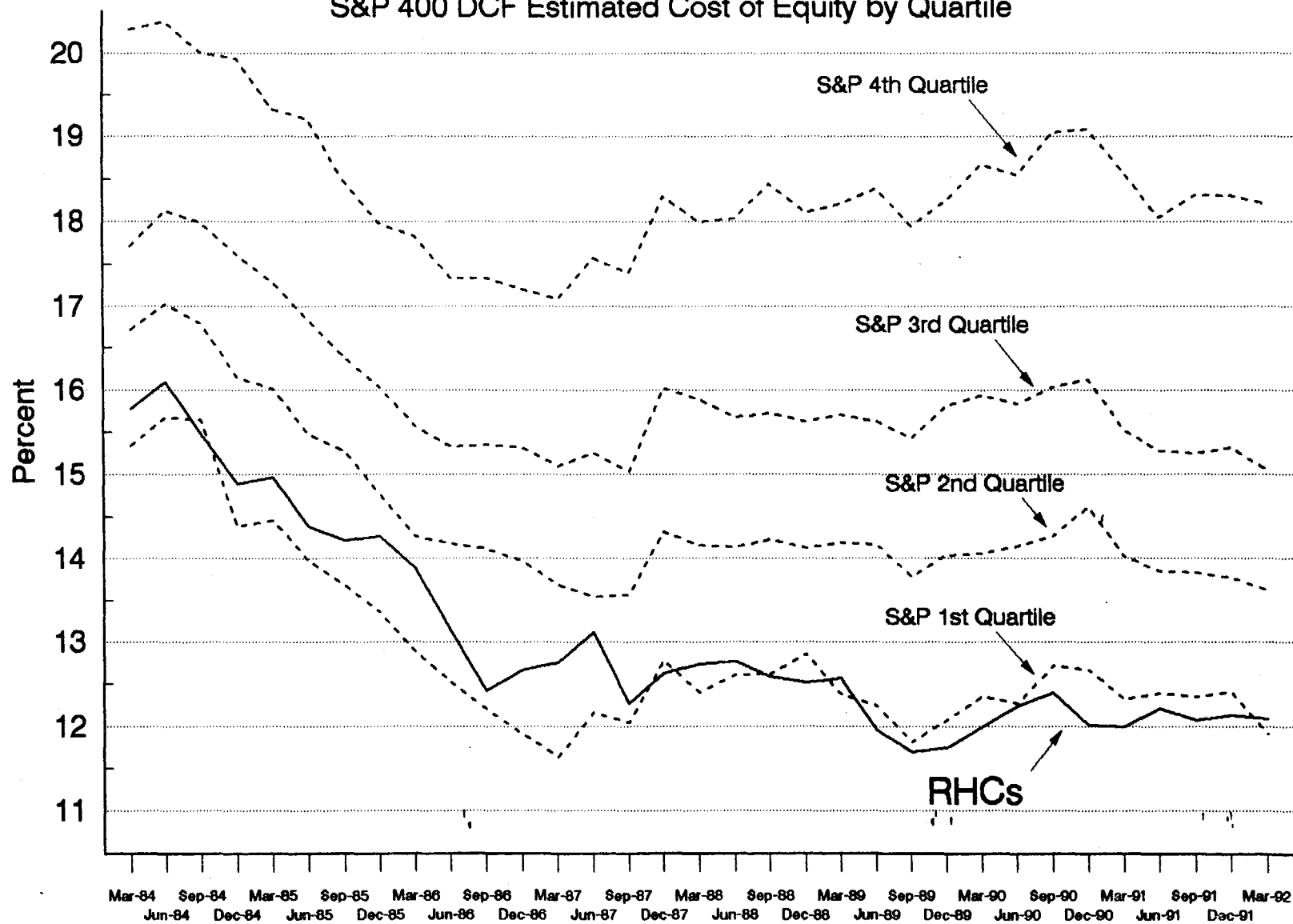
108. IT IS FURTHER ORDERED, pursuant to Sections 4(i) and 4(j) of the Communications Act of 1934, as amended, 47 C.F.R. §§154(i), 154(j), that Section 65.102(c) of the Commission's Rules, 47 C.F.R. §65.102(c), IS SUSPENDED, insofar as it requires the filing of rate of return submissions.

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy
Donna R. Searcy *WRC*
Secretary

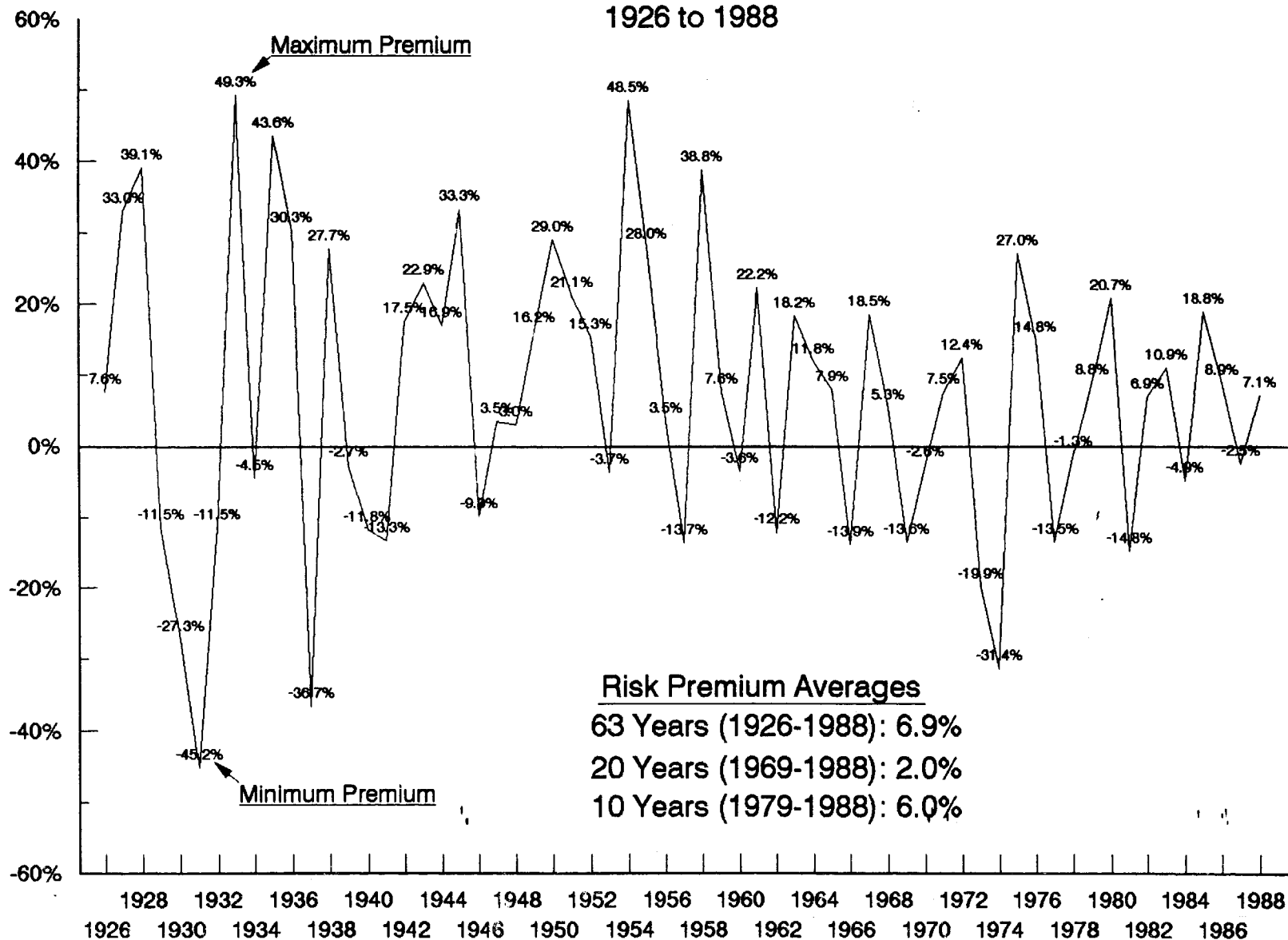
¹²² In related orders, we will address any issues remaining in Dockets 84-800 and 87-463.

Exhibit A
RHCs' DCF Estimated Cost of Equity
S&P 400 DCF Estimated Cost of Equity by Quartile



Ref:SPRHC92.DRW

Exhibit B
Historical Equity Risk Premiums
Common Stock Total Return* Minus Long-Term Government Bond Yields
1926 to 1988

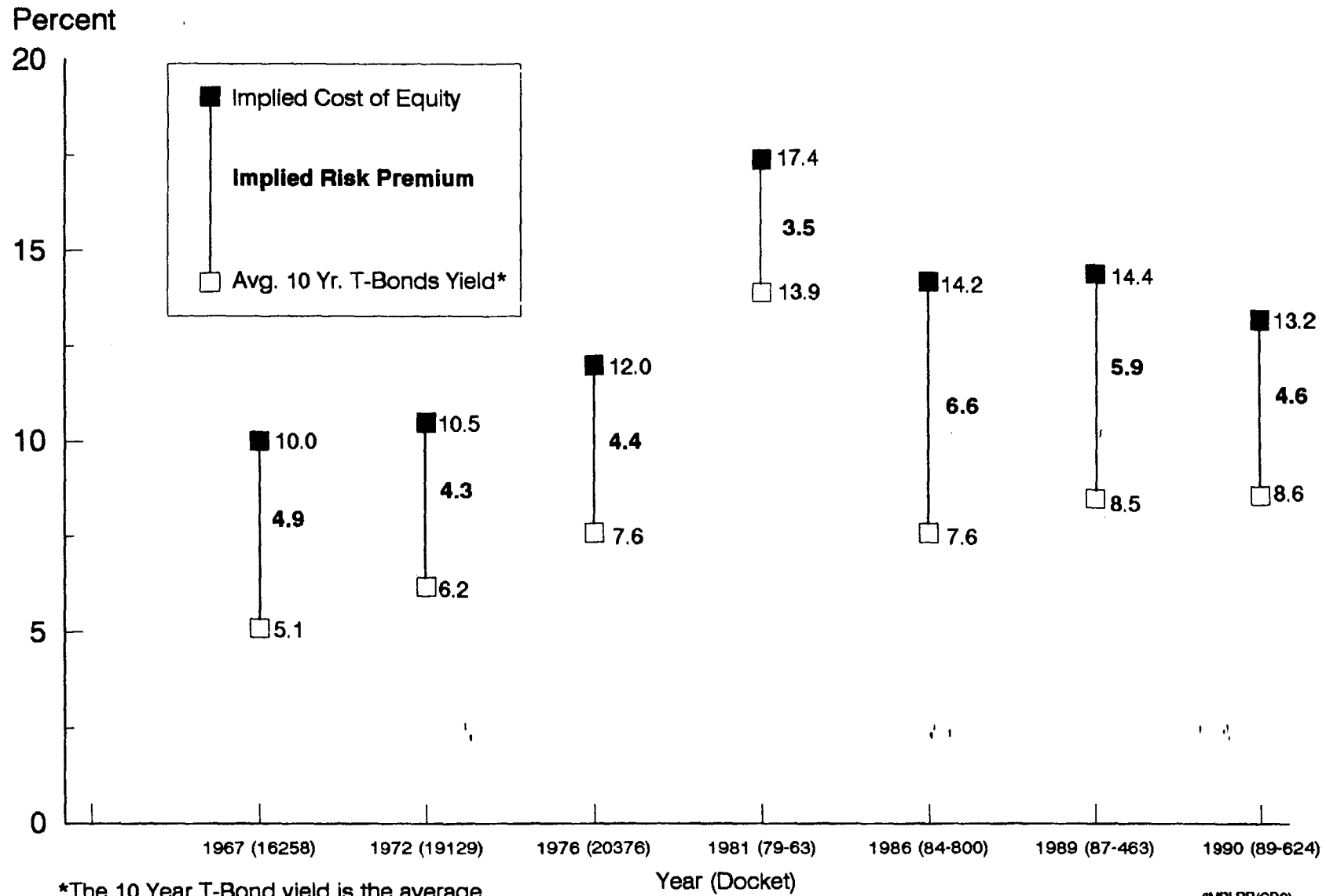


Source: SBBI 1989 Yearbook, Exhibit C-10

*The common stock total return is based upon the Standard & Poor's Composite Index. Currently this index includes 500 of the largest stocks, prior to 1957 it consisted of 90 of the largest stocks.

STKBONDS/GDS

Exhibit C Implied Risk Premiums for FCC Implied Cost of Equity



*The 10 Year T-Bond yield is the average for each calendar year.

(IMPLRP/GDS)

Exhibit D
Risk Premium Based on DCF of Lower Half of S&P 400
and Public Utility "Aa" Rated Bond Yields.

Year	Quarter	Public Utility "Aa" Rated Bond Yield*	Median DCF** Lower Half S&P 400	Risk Premium
		a	b	b-a=c
1982	1st	15.57%	18.34%	2.77%
	2nd	15.78%	17.94%	2.16%
	3rd	13.92%	17.26%	3.34%
	4th	12.76%	16.18%	3.42%
1983	1st	12.67%	15.94%	3.27%
	2nd	12.64%	15.76%	3.12%
	3rd	13.04%	15.92%	2.88%
	4th	13.14%	15.68%	2.54%
1984	1st	13.66%	16.03%	2.37%
	2nd	14.90%	16.36%	1.46% < -- Minimum Premium
	3rd	13.43%	16.22%	2.79%
	4th	12.76%	15.27%	2.51%
1985	1st	13.50%	15.24%	1.74%
	2nd	11.68%	14.73%	3.05%
	3rd	11.68%	14.48%	2.80%
	4th	10.57%	14.07%	3.50%
1986	1st	9.16%	13.58%	4.42% < -- Maximum Premium
	2nd	9.36%	13.35%	3.99%
	3rd	9.28%	13.16%	3.88%
	4th	8.81%	12.94%	4.13%
1987	1st	8.64%	12.66%	4.02%
	2nd	9.61%	12.85%	3.24%
	3rd	10.66%	12.80%	2.14%
	4th	10.78%	13.55%	2.77%
1988	1st	9.92%	13.28%	3.36%
	2nd	10.52%	13.37%	2.85%
	3rd	10.34%	13.42%	3.08%
	4th	9.90%	13.49%	3.59%
1989	1st	9.96%	13.46%	3.50%
	2nd	9.73%	13.27%	3.54%
	3rd	9.28%	13.13%	3.85%
	4th	9.26%	13.19%	3.93%
1990	1st	9.52%	13.22%	3.70%
	2nd	9.75%	13.11%	3.36%
	3rd	9.75%	13.48%	3.73%
	4th	9.59%	13.95%	4.36%
1991	1st	9.26%	13.37%	4.11%
	2nd	9.19%	13.04%	3.85%
	3rd	9.09%	13.09%	4.00%
	4th	8.83%	13.07%	4.24%
1992	1st	8.59%	12.86%	4.27%

*Source: Moody's Bond Record

**The DCF was calculated using the methodology applied in the 1990 Represcription Order (CC Docket 89-624). In that Order, those companies that paid no dividends, had less than five security analysts' estimates, or had DCF estimates less than the average corporate "A" rated bond yield were excluded from the calculations.